



Comptroller of the Currency  
Administrator of National Banks



# Red Flags in Board Reports

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## *A Guide for Directors*

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OFFICE OF THE COMPTROLLER OF THE CURRENCY  
Washington, D.C.

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# I. INTRODUCTION

Good decisions begin with good information. A bank's board of directors needs concise, accurate, and timely reports to help it perform its fiduciary responsibilities. This booklet describes information, generally found in board reports, that national bank directors use to meet their fiduciary responsibility. It highlights "red flags"—ratios or trends that may signal existing or potential problems. Effective directors are alert for the appearance of red flags, which give rise to further inquiry. By making further inquiry, the directors can determine if a substantial problem may be forming.

This booklet supplements other OCC publications including the *Director's Book: The Role of a National Bank Director* (March 1997) and the *Comptroller's Handbook* booklets.

As discussed in the *Director's Book*, the board of directors must oversee the bank's operations to ensure that the bank operates in a safe and sound manner and that risks to the institution are properly controlled. The board's responsibilities include keeping informed of the bank's operating environment, hiring and retaining competent management, maintaining an appropriate board structure, monitoring operations, overseeing business performance, and ensuring that the bank serves its community credit needs. The board of directors also establishes policies in major areas, holds management accountable for implementing those policies, and ensures that risks to the institution are properly managed.

The financial services industry has changed rapidly in the past decade, and the nature of the risk taking has increased in complexity and magnitude. Because of today's more complex business environment, it is critically important that directors understand and assess the potential or prospective impact of risk positions on future bank performance. Managing risk prospectively means measuring it accurately, understanding its implications, and ensuring that appropriate risk management

systems are in place before the risks lead to problems for the bank.

From a regulatory perspective, risk is the potential that events, expected or unanticipated, may have an adverse impact on the bank's capital or earnings. To control risk and mitigate its impact on the bank's financial performance, all banks must have risk management systems that identify, measure, control, and monitor risks. Strong risk management systems are particularly important when introducing new products or services or when the bank experiences strong growth.

The OCC has defined nine categories of risk for bank supervision purposes. These nine risks are: credit, liquidity, interest rate, price, foreign currency translation, compliance, strategic, reputation, and transaction. These risks are not mutually exclusive; any product or service may expose the bank to multiple risks.<sup>1</sup>

Because market conditions and organizational structures vary, there is no single risk management system that works in all banks. Each institution should tailor its risk program to its needs and circumstances. Effective risk management requires an informed board, capable management, and appropriate staffing. The board uses management reports and other information systems to stay well informed and assess risk within an institution. Board decisions based upon ineffective, inaccurate, or incomplete reporting may increase risk within the bank.

Although the board may depend on management's expertise to run daily operations, the board remains ultimately responsible for monitoring the bank's operations and levels of risk. The board can monitor the operations of the bank through management reports, but it must do more than merely accept and review these reports; it must be confident of their accuracy and reliability.

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<sup>1</sup> For a more complete discussion of the risks, refer to the "Bank Supervision Process" booklet of the *Comptroller's Handbook*.

Effective directors should ensure that management provides adequate and timely financial data and analyses that can answer questions such as:

- Is management meeting the goals established in the planning process? If not, why not?
- Was the plan realistic given the bank's circumstances?
- Is the level of earnings consistent, or erratic?
- Do earnings result from the implementation of planned bank strategies, or from transactions that, while increasing short-term earnings, raise longer-term risk?
- Is the bank being adequately compensated for the risks it is taking in its various product lines and activities?
- Does the bank have sufficient capital to support its risk profile and business strategies?
- Are the reports accurate, or do they reflect an incomplete evaluation of the financial condition of the bank?
- Are the bank's goals and plans consistent with the directors' tolerance for risk?

To assist boards of directors in assessing risk prospectively, this booklet identifies various leading indicators of increasing asset and credit quality, liquidity, and interest rate risk that should be a part of ongoing board reports. Other reports and performance measures outlined in this booklet are useful to directors in assessing the bank's current condition. This booklet is structured according to the types of information directors should receive. They should regularly receive reports on:

- Financial performance.
- Loan portfolio management.
- Liquidity risk management.
- Interest rate risk management.
- Investment portfolio management.



- Financial derivatives and off-balance-sheet activities.
- Audits and internal control.
- Consumer compliance.
- Asset management.
- Management information systems.
- Internet banking.
- OCC's overall assessment.

## II. REPORTS DIRECTORS SHOULD RECEIVE REGULARLY

### A. Financial Performance

Reports of financial performance should help directors assess the bank's condition, determine whether the level of risk taken by the bank conforms to the board's policies, and identify red flags. To use financial information effectively, directors should look at the trend and level of individual measures and the interrelationships among capital, asset quality, earnings, liquidity, sensitivity to market risk, and balance sheet growth. Financial reports should focus on **comparative financial statements** and **key financial performance ratios** and highlight areas of key risks.

**Comparative financial statements** include:

- Income statements for the month and year-to-date, which are compared with the budget and with results from prior years.
- Balance sheets for the month and year-to-date, which compare balances in individual asset and liability categories with balances at the same date in the previous year and with projections, if appropriate.

In reviewing these items, directors should identify any item that has changed significantly or that varies significantly from the budget, generally 10 percent or more, and should ask management why to explain the deviation.

Directors should regularly receive and review reports from management that contain **key financial performance ratios** and trends therein so that they may effectively monitor risk and financial performance. Many such ratios, including those referred to in the following paragraphs, may be found in the quarterly Uniform Bank Performance Report (UBPR), while others will be computed from internal bank records. The UBPR, which is computer generated from bank call report data and provided by the OCC, contains both historical and peer group

information. (A bank's peer group includes banks of similar size, type, and location.) The UBPR can help directors evaluate a bank's current condition, trends in financial performance, and comparisons with its peer group.<sup>2</sup> Directors should determine the reason for significant variances in the bank's performance when compared to the peer group.

## 1. Capital

Capital is the cushion that protects banks and their customers and shareholders against loss resulting from the assumption of risk. As a result, the adequacy of capital is very closely related to the individual risk profile of each bank. Overall capital adequacy of a bank is measured both quantitatively and qualitatively. The quantitative analysis focuses on risk-based and leverage ratios. The qualitative assessment considers the quality and level of earnings, the quality of assets, the bank's business strategy, the effectiveness of risk management, and management's overall ability to identify, measure, monitor, and control risk.

Management and the board determine how much capital the bank must hold. This determination may change over time based on the risk inherent in the bank's business profile, dividend expectations of the bank's shareholders, economic variables that affect the bank's market or customer base, and other factors. Although banks must maintain minimum capital ratios established in risk-based capital guidelines, most banks are expected to maintain a capital ratio higher than those minimums.

Adequate capital supports future growth, fosters public confidence in the bank's condition, provides for adequate capacity under the lending limit to serve customers' needs, and protects the bank from unexpected losses. The following ratios

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<sup>2</sup> Custom peer group information is available to national banks through the OCC National Banknet Comparative Analysis Reporting system (CAR). Access to the OCC National Banknet may be obtained through the OCC extranet site, <http://www.nationalbanknet.gov>.

can help directors evaluate the bank's capital adequacy and monitor compliance with regulatory minimum requirements:

- **Tier 1 capital/adjusted average assets**—the amount of capital supporting the bank's loans and other assets. Tier 1 capital includes the purest and most stable forms of capital. This ratio is commonly referred to as the leverage ratio.
- **Tier 1 capital/risk-weighted assets (tier 1 risk-based ratio) and total capital/risk-weighted assets (total risk-based ratio)**—the amount of capital in relation to the amount of credit risk associated with assets on and off the balance sheet. Total capital adds limited amounts of other capital to the tier 1 level.
- **Cash dividends/net income**—the percentage of net income paid out to shareholders in dividends.
- **Equity growth rate versus asset growth rate**—measures the extent to which capital growth is keeping pace with asset growth.

All insured depository institutions are subject to the prompt corrective action (PCA) framework outlined in 12 CFR 6.4. Under the PCA framework a bank is subject to certain restrictions that increase in severity as the capital category of the bank deteriorates. These restrictions begin to apply when a bank falls below "adequately capitalized." An adequately capitalized bank must apply for and receive a waiver from the Federal Deposit Insurance Corporation (FDIC) before it can accept, renew, or roll over brokered deposits. A bank is "adequately capitalized" if:

- Its leverage ratio is at least 4 percent.
- Its leverage ratio is at least 3 percent if the bank is rated 1 in the most recent examination.
- Its tier 1 risk-based ratio is at least 4 percent.
- Its total risk-based ratio is at least 8 percent, and
- It does not meet the definition of a "well capitalized" bank.

Complete information on the “adequately capitalized” category, as well as the four other categories of capitalization, is published in 12 CFR 6.4. Banks in the four lower categories are subject to certain supervisory restrictions.

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### **Capital Red Flags:**

- Ratios below “adequately capitalized.”
- Declining capital levels or ratios.
- Concentration in nontraditional activities.
- Capital growth rate is less than total asset growth rate.
- Dividend payout ratio is significantly higher than peer ratios.
- Ratios significantly different from peer ratios.

## **2. Asset Quality**

Asset quality is a function of the quantity of existing and potential credit risk associated with the loan and investment portfolios, other real estate owned (OREO), other assets, and off-balance-sheet transactions. Management maintains asset quality by identifying, measuring, monitoring, and controlling credit risk. Effective directors ensure that adequate underwriting and risk selection standards, sound credit administration practices, and appropriate risk identification practices exist.

When evaluating asset quality, directors consider the adequacy of the allowance for loan and lease losses; the level, distribution, severity, and trend of problem; classified, nonaccrual, restructured, delinquent, and nonperforming assets; the existence of concentrations of credit; credit risk arising from off-balance-sheet transactions; loan growth; and the volume and nature of credit policy and documentation exceptions.

Directors should regularly review the following credit risk and asset quality **leading indicators** for signs of increasing credit risk:

- **Loan growth**—measures the rate of growth in total loans and leases. Rapid growth, particularly as measured against local, regional, and national economic indicators, has long been associated with subsequent credit quality problems.
- **Loans to equity**—measures the multiple of bank equity capital invested in loans. All other factors held equal, as this ratio increases, so does risk to bank capital from credit risk. When this ratio is high, bank capital may be disproportionately affected by events that have an adverse impact on credit quality.
- **Change in portfolio mix**—measures the change in the composition of the portfolio over a given time frame. Changes in portfolio mix may indicate increasing risk, or decreasing risk. The larger the change the greater the reason to investigate its affect on the credit risk profile.
- **Adjusted reserve<sup>3</sup> to adjusted loans<sup>4</sup>**—measures allowance for loan and lease losses (ALLL) coverage of loans net of credit card loan losses, residential mortgages, and home equity loans adjusted by a historical loss factor, and noncurrent loans. The residual amount is presumed to be available to cover losses on remaining loan exposures. A ratio of zero or less may indicate that credit risk is high relative to reserve coverage and that the bank may need to adjust the ALLL.
- **Loans to assets**—measures the percentage of the bank's total assets that are invested in loans. As this percentage increases, so can credit risk.

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<sup>3</sup> **Adjusted reserves** is the **total of** the loan loss reserve **less the sum of** annualized losses for credit cards, one-to-four family residential and home equity (adjusted downward by an historical loss factor of 25 basis points), and noncurrent loans.

<sup>4</sup> **Adjusted loans** is the **total of** all loans **less the sum of** credit cards, residential one-to-four family mortgages, and noncurrent loans.

- **Loan yield**—measures the yield on the loan portfolio. The yield on the loan portfolio should reflect the risk of default and loss in the underlying loans as well as risks in the portfolio. High yields may indicate higher credit risk.

In addition to these ratios, directors can use the following ratios to assess the current condition of the portfolio.

- **Noncurrent loans and leases/total loans and leases**—the percentage of the loan portfolio not performing as agreed (i.e., loans and leases 90 days or more past due plus loans and leases not accruing interest). This measure is also referred to as nonperforming loans.
- **Noncurrent loans and leases/equity capital**—the percentage of the bank's permanent capital base threatened by noncurrent loans. The calculation for this ratio may include the ALLL in the denominator because the ALLL is available to absorb loan losses without reducing capital.
- **ALLL/total loans and leases**—the percentage of total loans the bank has set aside (reserved) to cover possible losses in the loan portfolio.
- **ALLL/net loan and lease losses**—the number of times the existing loan loss reserve would be able to cover the bank's losses during a given period.
- **Noncurrent loans and leases/ALLL**—the percentage of the loan loss reserve that would be required to absorb losses on noncurrent loans.
- **Net loan and lease losses/average loans and leases**—the percentage of the loan portfolio charged off during the period.

## Asset Quality and Credit Risk Red Flags:

- Significant increase in loans to total assets ratio.
- Significant increase in loan to equity ratio.
- Significant change in portfolio mix.
- Significant upward or downward trend in the percent of the ALLL to total loans and leases.
- High growth rates in total loans or within individual categories of loans.
- Significant increase in loan yields.
- Loan yields significantly higher than peer group.
- Downward trends in risk ratings among pass credits, and or increases in special mention or classified assets.
- Increasing levels of past-due and nonperforming loans, loan losses, interest earned not collected, OREO, or other repossessed assets as a percent of loans or assets.
- Stable or declining ALLL at the same time net loan losses are trending upward.
- Significant changes in the ALLL.
- Significant increases in ALLL provisions.
- Annual net charge-offs that exceed the balance in the ALLL.
- ALLL averages and percentages significantly different from the peer group's.
- Any significant changes in the above relative to historical performance, planned performance, or peer performance.



### 3. Earnings

The directors' review of earnings focuses on the quantity, trend, and sustainability or quality of earnings. A bank with good earnings performance can expand, remain competitive, augment its capital funds, and, at the same time, provide a return to shareholders through dividends. When a bank's quantity or quality of earnings diminishes, the cause is usually either excessive or inadequately managed credit risk or high levels of market risk. High credit risk, which often requires the bank to add to its ALLL, may result in loan losses; high market risk may increase the volatility of an institution's earnings from interest rate changes. The quality of earnings may also be diminished by undue reliance on extraordinary gains, nonrecurring events, or favorable tax effects. Future earnings may be adversely affected by an inability to forecast or control funding and operating expenses, improperly executed or ill-advised business strategies, or poorly managed or uncontrolled exposure to other risks.

The level and trend of the following measures, compared with the bank's previous performance and the current performance of peer banks, are important in evaluating earnings:

- **Net income/average assets**—how efficiently the bank's assets generate earnings. This ratio, commonly referred to as *return on average assets* (ROAA), is a primary indicator of profitability.
- **Net income/average total equity**—the rate of return on the shareholders' investment. This ratio is commonly referred to as *return on equity* (ROE).
- **Net interest income/average earning assets**—the difference between interest earned (on loans, leases, federal funds, etc.) and interest paid (for deposits, federal funds, etc.) compared with average earning assets. This ratio is commonly referred to as the *net interest margin* (NIM). Net interest income has historically been most banks' largest source of earnings. Directors also look at the components of interest income and expense to identify changes in volume and spreads.

- **Noninterest income/average assets**—bank reliance on income derived from bank services and sources other than interest-bearing assets. Effective directors review sources and volatility of and significant changes in noninterest income.
- **Overhead (noninterest) expense/average assets**—efficiency of the bank’s operations. Although controlling overhead expense is important, directors should be alert for too much cost-cutting, e.g., reducing staff and forgoing information systems upgrades. Such decisions may expose the bank to significant risks that could impair future earnings.
- **Provision expense/average assets**—the relative cost of adding to the loan loss reserve. Loan losses erode capital and reduce earnings. The loan report to the board should describe how earnings will be affected by anticipated loan losses. For more about the loan report, see the “Loan Portfolio Management” section of this booklet.

## Earnings Red Flags:

- Significant increases or decreases in noninterest income.
- Significant variances from budgeted amounts on income/expense items and balance sheet accounts.
- Significantly higher or lower average personnel expenses than peer banks.
- Significant variances in the ROAA, ROE, or NIM from prior periods and as compared to peer group.

## 4. Liquidity

When evaluating liquidity, directors compare the current level of liquidity, plus liquidity that would likely be available from other sources, with funding needs, and they determine whether funds management practices are adequate. Bank management should be able to manage unplanned changes in funding sources, as well as react to changes in market conditions that could hinder the bank's ability to quickly liquidate assets with minimal loss. Funds management practices should ensure that the bank does not maintain liquidity at too high a cost or by relying unduly on wholesale or credit-sensitive funding sources. These funding sources may not be available in times of financial stress or when market conditions are adverse. It is important to maintain an adequate level of liquid assets and a stable base of deposits and other funding sources.

Directors should regularly review the following liquidity **leading indicators** for signs of increasing liquidity risk.

- **Net loans/deposits**—indicates the extent to which a bank's deposit structure funds the loan portfolio. The higher the ratio the more reliance that a bank has on non-deposit sources to fund the loan portfolio.
- **Net noncore funding dependence**—calculated by subtracting short-term investments<sup>5</sup> from noncore liabilities<sup>6</sup> and dividing the resulting difference by long-term assets.<sup>7</sup> This ratio

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<sup>5</sup> **Short-term investments** include interest bearing bank balances, federal funds sold and securities purchased under agreements to resell, fixed or floating debt securities that mature within one year, and commercial paper and banker's acceptances.

<sup>6</sup> **Non-core liabilities** is the sum of time certificates of deposit (CDs) and open time deposits greater than \$100M, other borrowed money, foreign office deposits, federal funds sold or securities sold under agreements to repurchase, brokered deposits issued in denominations less than \$100M, and demand notes issued to the U.S. Treasury.

<sup>7</sup> **Long-term assets** are loans and securities maturing or repricing in over five years and collateralized mortgage obligations (CMOs) with remaining maturity over three years.

indicates the degree of reliance on funds from the professional money markets to fund earning assets. Professional markets are credit and price sensitive. These funds will move out of the bank in the event of real or perceived asset quality or other fundamental problems at the bank.

- **Net short-term liabilities/total assets**—calculated by taking the difference in short-term assets from short-term liabilities<sup>8</sup> and dividing by total assets. The ratio indicates the degree of exposure assumed by funding assets with short-term liabilities, also referred to as rollover risk. Generally, the higher the number, the more vulnerable the bank is to funding sources rolling out. This requires the bank to find new funding sources for existing assets.
- **On-hand liquidity/total liabilities**—calculated by dividing net liquid assets<sup>9</sup> by total liabilities. This ratio measures the bank's ability to meet liquidity needs from on-hand liquid assets. The lower the ratio, the greater the likelihood that the bank will need to sell less liquid assets or use market funding sources to meet incremental liquidity needs.
- **Reliance on wholesale funding**—calculated by dividing all wholesale funding by total funding. This measures the portion of the bank's total funds that are from wholesale sources. Banks with high volumes of wholesale funding need to make sure they have up-to-date contingency funding plans.

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<sup>8</sup> **Short-term liabilities** include fixed or floating rate deposits less than \$100M that mature within one year, fixed or floating rate time CDs less than \$100M that mature within one year, other borrowed money with remaining maturities less than one year, deposits in foreign offices with maturities less than 1 year, federal funds purchased and securities sold under repurchase agreements, and demand notes to the U.S. Treasury.

<sup>9</sup> **Net liquid assets** is the sum of interest-bearing bank balances, fed funds sold, reverse repos (securities purchased under agreement to resell), the fair value of assets held-for-sale securities, and the book value of held-to-maturity securities less the sum of fed funds purchased, repos (securities sold under an agreement to repurchase), and pledged securities.

The following indicators can also help directors determine the **current** liquidity position and can be found on the UBPR.

- **Net loans/core deposits**—the percentage of the loan portfolio funded by core deposits. Core deposits are demand and savings deposits, NOW (negotiable order of withdrawal) accounts, money market accounts, and other time deposits of less than \$100,000.
- **Short-term investments/total assets**—the percentage of bank assets that can be readily converted into cash. Short-term investments are items such as federal funds sold, repurchase agreements, and debt securities with remaining maturities of one year or less.
- **Short-term investments/short-term noncore funding**—the percentage of the bank's short-term noncore liabilities, e.g., federal funds purchased and certificates of deposit of \$100,000 or more, that are matched by short-term assets.

Directors may find reports on the following useful: sources of liquidity, potential off-balance-sheet funding needs, deposit and other funding concentrations, projected sources and uses of funds, and the contingency funding plan.



## Liquidity Red Flags:

- Significant increases in reliance on wholesale funding.
- Significant increases in large certificates of deposit, brokered deposits, or deposits with interest rates higher than the market.
- Mismatched funding—funding long-term assets with short-term liabilities or short-term assets with long-term liabilities.
- Significant increases in borrowings.
- Significant increases in dependence on funding sources other than core deposits.
- Reduction in borrowing lines by correspondent banks.
- Increases in cost of funds.
- Declines in levels of core deposits.
- Significant decreases in short-term investments.

## 5. Sensitivity to Market Risk

To assess the bank's sensitivity to market risk, directors determine how changes in interest rates, foreign exchange rates, commodity prices, or the value of equity can reduce the bank's earnings or capital. For many banks, the primary source of market risk is interest rate risk, i.e., the sensitivity to changes in interest rates. In some larger institutions, foreign operations and/or trading activities can be a significant source of market risk.

The following ratios can help directors evaluate the bank's sensitivity to changes in interest rates.

- **Long-term assets/total assets**—commonly used as an indicator of repricing risk. A higher ratio generally suggests that a bank has a sizeable amount of assets that cannot be repriced for a long period of time. If interest rates rise, such assets will lose value and depreciate, as they will be paying lower yields relative to prevailing market rates.
- **Nonmaturity deposits/long-term assets**—estimates the degree that nonmaturity funding sources cover long-term assets on the balance sheet. Such sources include demand deposit accounts (DDA), money market demand accounts (MMDA), savings and NOW accounts. Banks with high ratios should be less vulnerable to increases in interest rates.
- **Residential real estate mortgages, mortgage-backed securities, and structured notes/total assets**—indicates the magnitude of short options risk (also called negative convexity) in the balance sheet. With short options positions, the bank has provided their customers the option of either prepaying the asset when rates are low or not pre-paying when rates rise. Short options increase a bank's interest rate risk by compressing margins in both rising and falling rate environments.

- **Asset depreciation/tier 1 capital**—measures the proportion of capital offset by estimated depreciation in the available-for-sale and held-to-maturity investment portfolios, plus an estimate of potential depreciation in the residential loan portfolio. Depreciation in all these assets is usually the result of yields that are below market rate.

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### **Interest Rate Risk Red Flags:**

- Capital falling below the level established by the board to support interest rate risk.
- Significant increases or decreases in the percent of long-term assets to total assets.
- Significant decrease in the percent of nonmaturity funding sources to long-term assets.
- High or increasing percent of asset depreciation to tier 1 capital.



## 6. Growth

Directors also look at the effect of growth on the bank's asset quality, earnings, capital, liquidity, and exposure to risk. Rapid growth may harm the bank as the bank may assume more risk than expected. Managing additional risk or a new risk profile can be costly and strain resources. In a growth environment, personnel with the requisite expertise must be handling new lines of business or assuming additional responsibility. The bank must also have control and information systems that are adequate to handle the bank's increase in size and its greater exposure to risk.

Directors identify growth patterns by comparing historical and budgeted growth rates for assets, capital, loans, volatile liabilities, core deposits, and income and expenses. Comparing the bank's growth rates with those of its peers may also indicate whether the bank is growing inordinately.

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### **Growth Red Flags:**

- Growth that is not consistent with the bank's budget or strategic plan.
- Growth that is not accompanied by an increasing level and sophistication in risk management controls.
- Introduction of new products or activities with little or no expertise or inadequate risk management controls.
- Growth that is significantly greater than that of peer banks, even if projected in the bank's budget or strategic plan.
- Higher risk profile than forecast.
- Declining capital levels or ratios.
- Reliance on unstable or short-term funding sources.

## **B. Loan Portfolio Management**

Boards that effectively manage the loan portfolio understand and control the bank's risk profile and its credit culture. To accomplish this, directors have a thorough knowledge of the portfolio's composition and its inherent risks. The directors also understand the portfolio's industry and geographic concentrations, average risk ratings, and other lending characteristics. They also ensure that the bank has appropriate staffing and expertise for all of its lending activities and that management is capable of effectively managing the risks being assumed.

Directors identify adverse trends in the loan portfolio and judge the adequacy of the allowance for loan and lease losses (ALLL) by reviewing the loan reports. The board, or a loan committee of directors, receives information on new and renewed loans, participations purchased and sold, past-due and nonperforming loans, other real estate owned (OREO), problem loans and trends in risk ratings identified by management and examiners, charge-offs and recoveries, management's analyses of the adequacy of the ALLL, composition of the loan portfolio, concentrations of credit, credit and collateral exceptions, and customers with large total borrowings. Comparative and trend data is usually best presented in graph form.

### **1. Loan Quality**

Normally, the most readily available information for directors concerning loan quality comes from management's internal risk rating reports, reports on past-due and nonaccrual loans, renegotiated and restructured loan reports, and policy exception reports. Reviewing these reports can help directors identify negative trends early.

## Directors review:

- **Risk rating reports**—summarize the total dollar amount of loans in each risk rating category, often by division or product. This report is especially useful to monitor risk rating trends. In addition to the problem loan categories, the OCC strongly encourages banks to develop multiple pass (non-problem) rating grades so that negative trends in overall loan quality can be identified quickly.
- **Problem loan reports**—identify problem or watch credits and quantify the bank's potential loss on each significant problem credit. The bank's internal loan classifications should be updated and summarized periodically and should be easily translatable to the OCC classification system (pass, special mention, substandard, doubtful, and loss). Effective directors understand why a loan is a problem and what action management is taking to strengthen it.
- **Past-due and nonaccrual reports**—show seriously delinquent borrowers and tell the percent of loans past due by loan category (i.e., commercial, installment, real estate). Effective directors understand the reasons for delinquencies.
- **Renegotiated and restructured loan reports**—identify loans whose original terms or structure has been modified. High levels of renegotiated or restructured loans can signal an attempt by a loan officer or management to mask the true number and amount of past-due loans. Effective directors understand why a loan was restructured or terms were renegotiated.
- **OREO reports**—detail efforts to dispose of each piece of other real estate owned (generally foreclosed properties) and show if appraisals are current for all parcels.
- **Exception reports**—list exceptions to loan policies, procedures, and underwriting standards. The reports should include the trend in number and dollar amount of loans approved that are exceptions to policy as well as the

percentage of loans that are exceptions to policy. Directors require that management explain these exceptions and determine whether to re-enforce or revise loan policies.

## **2. Allowance for Loan and Lease Losses**

The allowance for loan and lease losses is a valuation reserve charged against the bank's operating income. Directors ensure that the estimates are reasonable and the allowance covers all estimated inherent loan and lease losses.

Directors review the following information to determine whether the ALLL is adequate:

- Management's quarterly evaluation of the adequacy of the ALLL, prepared as of call report dates.
- Management's problem loan list.
- Charge-off and recovery experience.
- A reconciliation of the ALLL for the current period and previous year-end.
- Any independent analysis of the ALLL (e.g., external loan review).

## **3. Loan Summary**

Board members can find out what types of loans the bank is making and management's lending practices by looking at lists of new credits approved, loans renewed, concentrations of credit, and participations purchased and sold. Management and the board together should establish dollar limits for the loans detailed in those reports.

## Loan Portfolio Red Flags:

- Large or increasing volume of loans granted or renewed with policy exceptions.
- Large or increasing volume of credit/collateral exceptions.
- Loans remaining on the problem loan list for extended periods of time without improvement.
- Loan review personnel reporting to a person(s) other than the board or a board committee.
- Delinquent internal loan reviews or late identification of problem loans.
- Large concentrations of credit to individuals or industries with or without prior board approval.
- Loans to directors, significant shareholders, management, and other insiders (including third parties performing services for the bank, external accountants, auditors, and marketing firms).
- Loans to affiliates.
- Excessive out-of-territory lending.
- Loans to borrowers who appear on the overdraft or uncollected funds reports.
- Rapid growth in total loan volume or particular types of lending.
- Growth in the ALLL that is significantly greater or less than the percentage growth in total loans over a given period.
- Nonperforming or problem loans as a percentage of total loans increasing at a greater rate than the ALLL.
- Loan officer compensation that is tied to growth or volume targets.
- High or increasing yield on the loan portfolio.
- Significant shifts in the bank's risk rating profile or increase in the number or dollar amount of problem or watch loans as a percent of loans, in aggregate, or for loan types.

## C. Liquidity Risk Management

Effective liquidity risk management requires an informed board, capable management, and appropriate staffing. The board and senior management are responsible for understanding the nature and level of liquidity risk assumed by the bank and the tools used to manage that risk. The board and senior management should also ensure that the bank's funding strategy and its implementation are consistent with their expressed risk tolerance.

The board of directors' primary duties are establishing and guiding the bank's strategic direction and tolerance for liquidity risk; selecting senior managers who will have the authority and responsibility to manage liquidity risk; monitoring the bank's performance and overall liquidity risk profile, and ensuring that liquidity risk is identified, measured, monitored, and controlled.

The following reports should assist directors in assessing the bank's liquidity risk:

- **Liquidity risk report**—shows the level and trend of the bank or banking company's liquidity risk by a variety of appropriate measures. Report should indicate how much liquidity risk the bank is assuming, whether management is complying with risk limits, and whether management's strategies are consistent with the board's expressed risk tolerance.
- **Funds provider report**—lists large funds providers and identifies funding concentrations. These reports should include consolidated information from all commonly owned banks.
- **Funds flow analysis**—reflects trends of balance sheet line items, in dollar terms, which have a significant impact on liquidity. Changes over time can be useful in developing a "source and use analysis" to more clearly show where money is coming into and going out of the bank or banking company.
- **Cash flow or funding gap report**—shows future time frames when funds may be needed to pay for deposit withdrawals,

or other decreases in liabilities, or increases in assets. The funding gap is a shortfall (or excess) of funds that is caused at certain points in time by a funding mismatch.

- **Contingency Funding Plan (CFP)**—may incorporate the funding gap report or be considered an outgrowth of it. The plan forecasts funding needs and funding sources (and therefore gap) under varying market scenarios resulting in rapid liability erosion (usually due to increasing customer concerns about the asset quality of the bank), or excessive asset growth (for example, due to early amortization of securitizations).

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### Liquidity Risk Red Flags:

- Liquidity risk that exceeds risk limits established by the board.
- A negative trend or significantly increased risk in any area or product line, particularly a decline in indicators of asset quality, or a decline in earnings performance or projections.
- Concentrations in either assets or liabilities indicating undue reliance.
- Rapid asset growth funded by wholesale, volatile liabilities, or brokered deposits. This may indicate poor credit underwriting standards.
- Increased funding costs due to customer or counterparty concerns about increasing risk.
- Eliminated or decreased credit line availability from correspondent banks, causing the bank to make larger purchases in the brokered funds or other potentially volatile markets.

## D. Interest Rate Risk Management

Effective oversight of the bank's interest rate risk activities is the cornerstone of an effective risk management process. Management and the board share responsibility for such oversight. The board must understand the nature and level of the bank's interest rate risk, determine whether that risk is consistent with the bank's overall strategies, and assess whether the bank's methods of managing interest rate risk are appropriate.

The directors establish the bank's tolerance for interest rate risk and monitor the bank's performance and overall interest rate risk profile. The directors also ensure that the level of interest rate risk is maintained at prudent levels and is supported by adequate capital. In determining whether capital support for interest rate risk is adequate, the board considers the bank's exposure to current and potential interest rate risk. Additionally, they consider the bank's exposure to other risks, such as credit, liquidity, and transaction risks.

Accurate and timely measurement of interest rate risk is necessary for proper risk management and control. The risk measurement system should be able to identify and quantify the major sources of the bank's interest rate exposure. Reports to the board should measure the bank's current interest rate risk position relative to earnings at risk and capital at risk limits.<sup>10</sup> The three most common risk measurement systems used to quantify a bank's interest rate risk exposure are **gap reports**, **simulation models**, and **economic value sensitivity models**.

- **Gap reports**—calculate the difference between rate-sensitive assets and rate-sensitive liabilities at various intervals or time periods. The gap at the one-year level can be used to calculate the amount of net interest income at risk. Gap reports are

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<sup>10</sup> See the "Interest Rate Risk" booklet (June 1997) of the *Comptroller's Handbook* for additional information on these risk limits.



generally used to evaluate how a bank's net interest income will be affected by a change in interest rates.

- **Simulation models**—may be used for measuring interest rate risk arising from current and future business scenarios. Earnings simulation models evaluate risk exposure over a period of time, taking into account projected changes in balance sheet structures, pricing, maturity relationships, and assumptions about new business and growth. Reports generally show future balance sheet and income statements under a number of interest rate and business-mix scenarios.
- **Economic value sensitivity models**—can capture the interest rate risk of the bank's business mix across the spectrum of maturities. These models generally compute the present value of the bank's assets, liabilities, and off-balance-sheet accounts under alternative interest rate scenarios and the sensitivity of that value to changes in interest rates.

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### Interest Rate Risk Red Flags:

- The inability of management to provide reports that identify and quantify the major sources of the bank's interest rate risk in a timely manner and describe assumptions used to determine interest rate risk.
- Noncompliance with the board's established risk tolerance levels and limits.
- Unauthorized exceptions to interest rate risk policy.
- Changes in the level and trends of aggregate interest rate risk exposure.
- Significant changes in net interest income.

## **E. Investment Portfolio Management**

Banks own investment securities and money market assets in order to manage asset and liability positions, diversify their earning assets base, maintain a liquidity cushion, and meet pledging requirements. For most national banks, the investment portfolio constitutes a significant earning asset. The increasing complexity of the securities available in the marketplace has heightened the need for effective management of the portfolio. Oversight of investment portfolio activities is an important part of managing the bank's overall interest rate, liquidity, and credit risk profiles.

Directors play a key role in overseeing the bank's investment activities. They establish strategic direction and risk tolerance limits; review the portfolio's activity, risk profile, and performance; and monitor compliance with authorized risk limits.

### **1. Selection of Securities Dealers**

Many banks rely on securities sales representatives, investment bankers, and brokers to recommend proposed investments, investment strategies, and the timing and pricing of securities transactions. Directors review and approve a list of securities firms with whom the bank is authorized to do business. Directors also ensure that dealers used by the bank are financially stable, reputable, and knowledgeable.

As part of the process of managing a bank's relationship with securities dealers, the board of directors may also want to consider prohibiting employees who are directly involved in purchasing and selling securities for the bank from engaging in personal securities transactions with the same securities firm the bank uses for its transactions without specific board approval and periodic review.

## 2. Categorization of Securities

When a bank purchases a security, it must decide under current accounting rules whether it intends to hold the security to maturity. If it does, the security may be classified as held-to-maturity and accounted for at historical cost. Held-to-maturity securities may be sold prior to maturity only if credit quality deteriorates or if other rare situations occur. The bank must classify other securities as available-for-sale and carry them at fair value (essentially market value). For accounting purposes, changes in fair value are reflected in the bank's capital.

Board members should ensure that bank management's original classification decisions are reasonable and are adhered to. Improper sales of held-to-maturity securities may require some or all of the bank's other held-to-maturity securities to be marked to fair value. If so and if the value of these securities has declined, the bank's capital could be greatly diminished.

Directors are ultimately responsible for supervising a national bank's investment portfolio. A bank's board may delegate investment decision-making authority for all or a portion of their investment securities portfolio to a nonaffiliated firm or to an individual who is not an employee of the institution or one of its affiliates. Such a delegation of authority is intended to obtain a higher total return on the portfolio than the institution would realize if it managed the portfolio itself. Because bank management would no longer control the portfolio, held-to-maturity securities would no longer qualify as such under GAAP, and they would have to be marked to market. Sales of these securities would be recorded as available-for-sale transactions on ledgers independent of the decision-maker's control.

### 3. Investment Reports

Directors find the following reports helpful in assessing the overall quality, liquidity, and performance of the investment portfolio:

- **Maturity breakdown and average maturity**—shows each sector of the investment portfolio (Treasuries, municipals, etc.) and the portfolio as a whole.
- **Distribution of credit ratings (by a major rating service) for all municipal and corporate securities**—shows the percent of the portfolio in each rating category. This report provides useful information on the overall credit quality of the portfolio.
- **Adjusted historical cost for each security relative to its current market value**—shows held-to-maturity securities' appreciation or depreciation not recorded on the books. For depreciated available-for-sale securities, it shows the amount recorded as an unrealized loss or gain against capital for accounting purposes.
- **Purchases and sales**—indicates the type of security, its par value, maturity date, rate, yield, cost and sales prices, as well as any profit or loss.
- **Sensitivity analysis of the value of the portfolio in different interest rate environments**—compares the value in each interest rate scenario with the current portfolio value, illustrating the amount of portfolio risk. This report also provides a means of assuring that management has complied with the board's tolerance for risk.
- **Summary of investments by obligor, industry, related obligor, geographic area, etc.**—shows concentrations of investments that directors should review.

## Investment Portfolio Red Flags:

- Purchase of individual securities that do not meet board guidelines on risk, quality, or quantity.
- Securities purchased without pre-purchase analysis.
- Securities purchased from only one securities dealer.
- Large numbers of below-investment-grade (lower than BBB or Baa) or unrated bonds.
- Significant changes in the type, quality, or maturity distribution of the portfolio.
- Sale of securities previously designated held-to-maturity, or transfer of securities from the held-to-maturity account to the available-for-sale account.
- High volume of purchases and sales.
- Purchase of securities based only on yield.
- Investment purchases from securities dealers not approved by the board of directors.
- Investment returns that are well above or below the market or peer group average.
- Significant depreciation in the market value of investments.
- The classification of high-risk securities as held-to-maturity, and low-risk, short-term securities as available-for-sale.
- Purchase of securities in excess of concentration limits.
- Significant amounts of securities pledged for repurchase agreements or public deposits.

## **F. Financial Derivatives and Off-Balance-Sheet Activities**

Banks are increasingly using financial derivatives and off-balance-sheet activities to manage financial risk and increase income. Directors ensure that these risk management activities do not severely reduce income streams and that the risks posed by the income-increasing activities are well managed.

In general, effective directors ensure that management has the expertise necessary to manage derivatives and off-balance-sheet activities and that the activities do not impair the bank's overall financial condition. Financial derivatives and off-balance-sheet activities can include financial contracts such as structured debt obligations, swaps, futures, options, caps, floors, credit derivatives, asset securitizations, and loan commitments. Each type of product presents unique risks that must be identified, measured, and monitored.

### **1. Financial Derivatives**

Financial derivatives derive their value from the performance of underlying interest rates, foreign exchange rates, equity prices, or commodity prices. A bank can use derivatives to reduce business risks, expand product offerings to customers, trade for profit, manage capital and funding costs, and alter the risk-reward profile of a particular item or an entire balance sheet. Like all financial products, derivatives present risk, and directors should make sure that this risk is managed as part of the bank's overall risk management structure. Additionally, directors need to make sure that the bank has appropriate expertise to manage all products used.

The safe and sound use of derivatives is contingent upon effective board and management oversight. The following reports should assist directors in assessing financial derivatives activity:

- **Current aggregate risk exposure**—identifies what the counterparty owes the bank today plus an estimate of what

the counterparty might owe in the future based upon possible changes in interest rates, commodity prices, or equity prices.

- **Trends in aggregate risk**—presents a pictorial or tabular representation of the bank's aggregate risk exposure over a period of time. This report may include board-specified limits that will show not only the trend in aggregate risk but also limit usage.
- **Trends in credit exceptions**—tracks the level of credit exceptions (e.g., past-due counterparty reviews, counterparty limit exceptions, netting agreements, or other standard industry agreements) over time. This report assists the board in evaluating the level of compliance with sound underwriting practices and credit administration. During the normal course of business there may be temporary exceptions to board-approved counterparty credit limits. However, an increasing volume of credit exceptions over time may indicate unintended or unwarranted relaxation of bank policies.
- **Concentrations of credit**—includes internal factors (e.g., counterparty, risk rating, tenor) and external factors (e.g., industries or countries). Boards can assess common characteristics among counterparties that may become a source of weakness and pose a risk to earnings and capital.
- **Compliance with policies and risk limits**—details compliance with all board-approved derivative limits.
- **Results of stress testing**—augments the bank's risk measurement process by altering market variables to determine which scenarios may pose significant risk to the derivative portfolio. Reports to the board should include the major assumptions used in each scenario. Stress testing is important for both market and credit risk.
- **Summary of current risk management techniques and management practices (annually)**—details the risk measurement techniques and why they are appropriate for the size and complexity of the bank's derivative portfolio.

Financial Accounting Standard 133, “Accounting for Derivative Instruments and Hedging Activities,” mandates that, effective June 30, 2000, derivatives must be recorded at fair value on the balance sheet.

## **2. Asset Securitization**

In asset securitization, interests in loans and other receivables are packaged, underwritten, and sold in the form of asset-backed securities. By using the securities markets to fund portions of the loan portfolio, banks can allocate capital more efficiently, access diverse and cost-effective funding sources, and better manage business risks. It is essential that the board determine whether the bank has the necessary resources and expertise to effectively engage in this business.

Although it is common for securitization transactions to receive substantial attention early in their tenure, the level of scrutiny generally declines over time. Effective directors ensure that transactions are supervised and monitored over the duration of the bank’s involvement. Management reports to the board should monitor the performance of the underlying asset pools for all outstanding deals. Although the bank may have sold the ownership rights and control of the assets, the bank’s reputation as an underwriter or servicer remains exposed.

The board of directors and bank management should ensure that:

- Independent risk management processes are in place to monitor securitization pool performance on an aggregate and individual transaction level. An effective risk management function includes appropriate information systems to monitor securitization activities.
- Management uses conservative valuation assumptions and modeling methodologies to establish, evaluate, and adjust the carrying value of retained interests on a regular and timely basis.



- Audit or internal review staffs periodically review data integrity, model algorithms, key underlying assumptions, and the appropriateness of the valuation and modeling process for the securitized assets retained by the institution. The findings of such reviews should be reported directly to the board or an appropriate board committee.
- Management maintains accurate and timely risk-based capital calculations, including recognition and reporting of any recourse obligation resulting from securitization activity.
- Internal limits are in place to govern the maximum amount of retained interests as a percentage of total equity capital.
- The institution has a realistic liquidity plan in place in case of market disruptions.

Reports to the board on revolving transactions (credit cards, home equity lines, etc.) and installment loans monitor, as appropriate:

- The gross and net portfolio yield.
- Delinquencies.
- The charge-off rate.
- The base rate (investor coupon plus servicing fees).
- Monthly excess spread.
- The rolling three-month average excess spread.
- The monthly payment rate.
- Principal prepayment speeds.
- Outstanding principal compared with original security size.
- Residuals.
- Policy exceptions.
- Covenant compliance.
- Exposure limits by type of transaction and aggregate transactions outstanding.

### 3. Loan Commitments

A formal loan commitment is a written agreement, signed by the borrower and lender, detailing terms and conditions under which a specified amount will be loaned. The commitment has an expiration date. For agreeing to make the accommodation, the bank usually requires the prospective borrower to pay a fee, to put up a compensating balance, or both. A commitment can be irrevocable, as is a standby letter of credit facility, requiring the bank to lend when the customer calls upon it to do so. Or the commitment may be revocable, predicated upon the customer meeting certain covenants, often financial ones.

Effective directors should ensure that bank policy supports a loan officer's refusal to advance funds when a borrower is financially troubled, covenants have been broken, or other adverse conditions have arisen. The board receives reports from management projecting the funding sources for loan commitments and line of credits (based on the anticipated usage of such commitments and lines).

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## Financial Derivatives and Off-Balance-Sheet Activities Red Flags:

- Participation in transactions without appropriate knowledge of derivatives or experience in the market.
- Substantial exposure to a counterparty whose ongoing ability to meet its obligations is uncertain.
- Advancing funds to borrowers in financial difficulty, noncompliance with covenants, or other circumstances that make lending to them imprudent.
- Inadequate funding sources for anticipated usage of loan commitments and lines of credit.
- Underestimating the impact of derivative or off-balance-sheet products on the bank's risk-based capital position.
- Accounting errors for certain derivative or off-balance-sheet products.
- High levels of off-balance-sheet activity relative to the bank's size.

## **G. Audits and Internal Control**

Well-planned, properly structured, and effective internal and external auditing and internal controls are essential to properly managing risk and to maintaining a safe and sound bank. The board of directors is responsible for establishing and maintaining effective audit functions. An effective internal auditing process meets statutory and regulatory requirements as well as other audit-related supervisory guidelines and standards. Directors cannot delegate their responsibility for oversight of the auditing function. However, they may delegate the design, implementation, and monitoring of specific internal controls to management and the testing and assessment of internal controls to others.

The internal control system should, with reasonable assurance, help prevent or detect: inaccurate, incomplete, or unauthorized transactions; deficiencies in the safeguarding of assets; unreliable financial and regulatory reporting; violations of laws or regulations; and deviations from the institution's own policies and procedures. Both internal and external auditors should monitor and evaluate the effectiveness of internal controls. The board of directors determines how intensive auditing must be to effectively test and monitor internal controls and to ensure the reliability of the bank's financial statements and reporting.

The board of directors considers whether the bank's control systems and auditing methods, records, and procedures are proper in relation to the bank's:

- Size.
- Organization and ownership characteristics.
- Business activities and product lines.
- Operational diversity and complexity.
- Risk profile.

- Methods of processing data.
- Applicable legal and regulatory requirements.

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### **Audits and Internal Control Red Flags:**

- Any indications that management is trying to control or inhibit communications from internal audit staff to the board of directors.
- A qualified, adverse, or disclaimer opinion from an external auditor.
- Unreconciled differences between trial balances, subsidiary ledgers, and the general ledger.
- Significant internal control or other deficiencies noted in audit reports that have not been corrected.
- Audit reports that do not address identified internal control weaknesses.
- An external auditor or audit firm that has a financial interest in the bank, loan from the bank, or other conflict of interest.
- The inability of management to provide timely and accurate financial, operational, and regulatory reports.
- Internal audit staff reporting to other than the board of directors or its audit committee.
- A significant decrease in the audit budget.
- A reduction or increased turnover in internal audit staff.
- Unexplained or unexpected changes in external auditor or significant changes in the audit program.
- Employees in key or influential positions who were not on vacation or otherwise absent for two consecutive weeks during the year.
- Internal or external auditors relying heavily on the other's conclusions.

## H. Consumer Compliance

Compliance with consumer laws and regulations is an integral part of a bank's business strategy. Violations and noncompliance can significantly impair a bank's reputation, value, earning ability, and business opportunity. To effectively monitor compliance with consumer laws and regulations, it is important that the board receive timely and accurate reports on compliance matters. To ensure that directors learn immediately about significant violations and noncompliance, the designated compliance officer should have direct access to the board. The board should periodically receive formal reports on compliance matters. The complexity and extent of reporting will vary with the complexity and extent of the bank's operations.

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### Consumer Compliance Red Flags:

- Significant deficiencies identified in compliance reviews that have not been corrected in a timely manner.
- Significant turnover or a reduction in the staff responsible for ensuring compliance with law or specific consumer products.
- Lack of evidence that compliance was adequately considered when new products and delivery systems were introduced.
- A significant increase in customer dissatisfaction and complaints (either received directly or sent to the OCC).
- Inadequate review of the compliance function by internal audit.
- Significant deviation from policy or operational standards.
- Lack of periodic reports to the board on compliance matters.
- The compliance officer reporting to someone other than the board of directors.

An effective board places special emphasis on three compliance areas: fair lending, the Community Reinvestment Act (CRA), and the Bank Secrecy Act (BSA).

# 1. Fair Lending

Fair lending is making credit available in accordance with the requirements of the Fair Housing Act, the Equal Credit Opportunity Act, and Regulation B. Compliance can be achieved simply by establishing prudent lending practices and by treating customers consistently. These practices include establishing clear standards and procedures for credit decisions, setting reasonable limits on discretion by lending personnel, and maintaining appropriate documentation.

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## Fair Lending Red Flags:

- An existing or proposed lending policy that includes, directly or indirectly, reference to any prohibited basis (race, color, national origin, religion, sex, age, marital status, familial status, handicap, receipt of public assistance, or the exercise of a right under the Consumer Credit Protection Act).
- Any statements by officers, employees, or agents indicating a preference, prejudice, or stereotyping on a prohibited basis, or an aversion to doing business in minority areas.
- Segmentation of product markets, advertisements, promotions, application channels, or other access to credit along the lines of racial or national origin characteristics of applicants or geographic areas.
- Consumer complaints alleging discrimination in specific transactions.
- Substantially fewer loans originated in areas with relatively high concentrations of minority group residents than in areas with comparable income levels but relatively low concentrations of minority residents.
- An existing or proposed lending policy whose standards for underwriting, pricing, or setting terms and conditions are vague or unduly subjective.

## 2. Community Reinvestment Act

The Community Reinvestment Act (CRA) encourages national banks to help meet the credit needs of their entire communities. While the regulation no longer requires directors to document how actively they participate in community groups or civic organizations, the entire board's attention, leadership, and commitment is essential to successful CRA performance. Although the bank is not required to assess its CRA progress, periodic self-assessments can help the board determine the bank's progress toward achieving its internal CRA goals and performance objectives.

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### CRA Red Flags:

- Substantial disparities in the numbers of loans originated within groups of contiguous low- or moderate-income geographies.
- Reports that show lending performance significantly below the performance of other lenders in the bank's assessment area, particularly its primary competitors.
- Reports that show that the bank has few or no qualified investments in its assessment area even though investment opportunities exist.
- Customer complaints about the level of services and products offered in some parts of the bank's trade area compared with those offered in other areas served by the bank.



### 3. Bank Secrecy Act

The Bank Secrecy Act (BSA) and related regulations require that the board of directors approve a written program for compliance with the BSA. Compliance with BSA is an important part of the bank's operations. Noncompliance can result in serious harm to the bank's reputation and in the assessment of civil money penalties.

Effective directors ensure that the bank's program for BSA includes proper internal controls, independent testing, and appropriate staff training and that it is updated whenever regulatory changes take place. The bank's audit program should confirm that controls are adequate, that appropriate currency transaction reports (CTRs) and suspicious activity reports (SARs) are filed, and that the directors are informed about any SAR filings. The board designates an individual who is responsible for coordinating and monitoring day-to-day compliance.

Specifically, effective directors ensure that the BSA compliance program includes appropriate account opening procedures that verify the identity of the account holder, determine the nature and purpose of the account, and identify the bank's services or products the customer will use. Additionally an effective BSA program includes monitoring procedures to ensure that the bank is aware of any suspicious activities.

Directors and bank management are particularly alert to the following potentially high-risk accounts, services, and geographic areas:

- **High-risk accounts**—accounts held by currency exchange houses, casinos, car or boat dealerships, travel agencies, and entities from foreign countries known as drug trafficking or money-laundering havens. A high volume of cash, wire transfers, or official checks are also indicators of high-risk accounts.
- **High-risk services and products**—include private banking, payable through accounts, personal investment companies,

offshore accounts, international correspondent accounts, international pouch activity, and international wires.

- **High-risk geographic locations**—include areas known as drug trafficking or money-laundering havens.

## BSA Red Flags:

- Audit does not test for suspicious activity.
- Bank personnel are not regularly trained on the BSA and how to identify possible suspicious activity.
- The volume of SARs or CTRs is very high or very low.
- Customers have an unusually large volume of cash or use a disproportionate amount of cash versus checks.
- Customers use an unusually large volume of wires, official checks, money orders, or traveler's checks especially to or from a high-risk geographic area.
- The bank acquires large deposit relationships but management is unfamiliar with the depositor's business or line of work.
- Account activity is inconsistent with the known business of the account holder.
- Accounts have dramatic changes or spikes in activity or in the volume of money flowing through the account.
- Customers have multiple accounts for no apparent reason or make frequent transfers between accounts either within or outside the bank.
- Customer asks that his or her account be placed on the list of accounts exempt from CTR reporting requirements, or that the CTR not be filed, or makes cash deposits just under the CTR reporting threshold.
- Bank customers route funds through multiple foreign or domestic banks or wire funds in and out within a short period.
- Correspondence is received from the Internal Revenue Service regarding incomplete or incorrect currency transaction reports.

# I. Asset Management

Asset management services generally involve managing or selling investments to a third party. Asset management activities include trust-related services, retail brokerage, investment company services, and securities custody, and transaction processing services. National banks offer these services to strengthen competitiveness, meet customer demand, and enhance fee income. In many banks, asset management revenue is a significant contributor to total income and profitability.

National banks that provide asset management services operate in a legally complex environment and should identify and control the risks associated with the products and services it provides. Consequently, board oversight of asset management related activities is essential to effective management of these services. In discharging its responsibilities, the board may assign any function related to the exercise of fiduciary powers to any director, officer, or employee.

An effective board of directors will oversee the development of asset management related risk limits, approve new products or services, and monitor on-going business plans. Boards of directors should expect to routinely see financial performance reports related to each asset management business.

Directors generally find the following reports helpful in assessing the risks and financial performance of asset management activities:

- **New business/lost business reports**—identify key characteristics of new clients and provide information on closed accounts. Directors focus their attention on potential systemic reasons for account closings, including customer service problems, product deficiencies, mishandling of accounts, and operational errors.

- **Investment reports**—provide information on investments purchased and sold for fiduciary accounts. See the “Investment Portfolio Management” section of this booklet for additional information concerning the selection of securities dealers and investment reports addressing fixed income marketable securities.
- **Litigation reports**—summarize the volume, potential dollar exposure, and nature of pending or threatened litigation. These reports should provide current information on the status of existing litigation and should be reviewed by the bank’s legal counsel.
- **Profitability/budget reports**—may capture information by product line, by business unit, or for asset management activities as a whole. The supporting information should be sufficient for directors to evaluate the success of business strategies as well as management’s performance.
- **Fiduciary audit reports**—contains conclusions on the effectiveness of the bank’s internal controls and operating practices. Reports are usually separate audit reports and are required by 12 CFR 9.9.

## Asset Management Red Flags:

- Unanticipated or unexplained changes in business strategies.
- Substantial changes or growth in account types, account balances, or products and services offered.
- The existence of accounts with unusually high cash balances or large extended overdrafts.
- Accounts that are closed shortly after being opened and funded.
- High volumes of exchanged annuities, switched mutual funds, or early redemptions of retail brokerage investments.
- Purchases of fiduciary securities or sales of securities through a retail brokerage unit that were securities not previously approved by the board or investment committee.
- Fiduciary assets of a kind the bank lacks expertise to manage (e.g., mineral interests or farm/ranch properties).
- Unresolved significant audit and compliance findings.
- Significant levels of documentation deficiencies and policy exceptions including exceptions to account and business acceptance policies.
- Unexplained or frequent changes in vendors, service providers, or auditors.
- Significant outsourcing of services without management oversight and control.
- Purchase of assets for fiduciary accounts from the bank or bank insiders.
- Selling, lending, or transferring of fiduciary account assets to the bank or bank insiders.

## **J. Management Information Systems**

Many of a bank's business decisions are predicated on the sophistication and reliability of information systems. For example, many banks must either forgo offering certain new products or go to the expense of upgrading their information systems. Software and telecommunications, data processing, computer networks, and the Internet are all possible components of a bank's information system.

A bank's information system architecture has two major functions: processing bank transactions and supplying reports to management and the board about managing business risk. The management information systems (MIS) supply these reports. One of MIS's most important functions is to help management assess the bank's risk. Management decisions based on ineffective, inaccurate, or incomplete MIS may increase risk in all areas.

Because technological advancements are increasingly changing the character of day-to-day banking activities, effective board members learn as much as possible about their bank's information systems and are aware of any proposed changes to the systems.

Not all of a bank's transactions are processed inside the bank. Vendors of many kinds can be essential to the processing of bank transactions. If vendors play important roles in the bank's information systems, the board must ensure that the vendor's services and reports meet the same standards as those generated within the bank.

To assess a bank's information systems, the board considers whether the MIS process provides the information necessary to manage the organization effectively. A reliable MIS ensures that the bank maintains basic control over financial record keeping. The MIS also should support the institution's longer-term strategic goals and objectives.

The following characteristics of an MIS ensure prompt and well-informed decision-making:

- **Timeliness**—The systems should be able to expedite the reporting of information. The systems should be able to promptly collect and edit data, summarize results, and correct errors.
- **Accuracy**—A reliable system of automated and manual internal controls must exist for all information system processing activities. Information should receive appropriate editing, balancing, and internal control checks.
- **Consistency**—Consistency in how data is collected and reported is extremely important. Differences in these activities can distort trend analysis and information reported to the board.
- **Completeness**—Decision-makers require complete information in a summarized form. Reports should be designed to eliminate clutter and voluminous detail, thereby avoiding information overload.
- **Relevance**—MIS information is relevant if it is what the board, executive management, and the bank's operational areas need.

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### Management Information Systems Red Flags:

- A lack of system audits or unresolved audit deficiencies.
- Management is unable to provide a basic diagram of the system architecture or a comprehensive list of service providers.
- MIS reports that are untimely, incomplete, or inaccurate.
- Inconsistency of information contained within MIS reports.
- MIS reports that lack relevance or are too detailed for use as an effective decision-making tool.

## K. Internet Banking

Internet banking refers to systems that provide access to accounts and general information on bank products and services through a personal computer or other intelligent device. Internet banking products and services can include wholesale, retail, and fiduciary products. Ultimately, the products and services obtained through Internet banking may mirror products and services offered through other bank delivery channels.

Banks typically make their decision to offer Internet banking based on competition, cost efficiencies, geographical reach, branding, and customer demographics issues. Three basic kinds of Internet banking Web sites are being employed in the marketplace.

- **Informational**—The basic level of Internet banking.
- **Communicative**—Allows some interaction between the bank's system and the customer.
- **Transactional**—Allows customers to execute transactions.

Internet banking creates new risk control challenges for banks. An effective board ensures that management possesses the knowledge and skills to manage the bank's use of Internet banking technology and technology-related risks. Management must implement a system of internal controls commensurate with the bank's level of risk. The board reviews, approves, and monitors Internet banking technology-related projects. They determine whether the technology and products are in line with the bank's strategic goals and meet a need in their market. The board receives regular reports on the technologies employed, the risks assumed, and how those risks are managed.

To achieve a high level of confidence with both consumers and businesses, the Internet banking system must be secure. Key



components of a system that will help maintain a high level of public confidence in an open network environment include:

- **Security**—The level of logical and physical security must be commensurate with the sensitivity of the information and the individual bank's risk tolerance.
- **Authentication**—Customers, banks, and merchants need assurances they know the identity of the persons with whom they are dealing.
- **Trust**—A trusted third party, or certificate authority, is used to verify identities in cyberspace. Digital certificates may play an important role in authenticating parties and thus establishing trust in Internet banking systems.
- **Nonrepudiation**—The undeniable proof of participation by both the sender and receiver in a transaction is important. Public key encryption technology was developed to deal with this issue.
- **Privacy**—Concerns over the collection and use of personal information are likely to increase with the continued growth of electronic commerce. Banks should recognize and respond proactively to privacy issues.
- **Availability**—Users of electronic commerce capabilities expect access to networks 24 hours per day, seven days per week.

## Internet Banking Red Flags:

- Unresolved or repeat audit deficiencies.
- A system that does not have regular review and certifications by independent auditors, consultants, or technology experts.
- Management that is unable to provide a basic description of the system architecture, a comprehensive inventory of service providers, or effective vendor management.
- Systems, products, or services that are inconsistent with the bank's strategic plan.
- Web sites that do not meet customers' needs for information and privacy, and those without effective customer authentication.
- Systems without contingency and business resumption plans, or with a low level of operational reliability.
- No evidence that information was reviewed by the bank's compliance officer prior to distribution on the Web site.

## **L. OCC's Overall Assessment**

The board of directors reviews the report of examination to obtain the OCC's objective assessment of the bank. The report of examination addresses the bank's safety and soundness, the quantity of risk, the quality of risk management, the level of supervisory concern, and the direction of risk. Effective directors pay particular attention to weaknesses and adverse trends identified during the examination and to the actions management plans to take or has already taken to address those weaknesses. These topics are generally addressed in the "Matters Requiring Attention" and "Overall Conclusions" sections of the report of examination.

### **1. CAMELS**

The OCC and other federal bank and thrift regulatory agencies use the Uniform Financial Institutions Rating System (UFIRS) to assign composite and component ratings to an institution. This system is a general framework for uniformly evaluating the safety and soundness of banks. The UFIRS, also known as the CAMELS rating system, provides a point-in-time assessment of a bank's current performance, financial condition, compliance with laws and regulations, management ability, and overall operational soundness.

A bank's CAMELS composite rating integrates ratings in six component areas: the adequacy of capital (C), the quality of assets (A), the capability of management (M), the quality and level of earnings (E), the adequacy of liquidity (L), and the sensitivity to market risk (S). Ratings are also assigned for the specialty areas of information technology, trust, consumer compliance, and compliance with the Community Reinvestment Act.

Composite and component ratings range from 1 to 5 (with the exception of CRA, which has four rating categories.)

A composite or component rating of 1 is the highest and best rating, indicating the strongest performance and the best risk management practices relative to the institution's size, complexity, and risk profile. A bank rated 1 poses the least supervisory concern. A 5 rating is the lowest and worst rating, indicating the most critically deficient level of performance and inadequate risk management practices relative to the institution's size, complexity, and risk profile. A bank rated 5 poses the greatest supervisory concern.

## 2. Risk Assessment System (RAS)

The RAS is a method of identifying, evaluating, documenting, and communicating OCC's assessment of the quantity of risk, the quality of risk management, and the direction of risk at each bank. This assessment takes both a current and a prospective view of the institution's risk profile. The OCC has defined nine risk categories: credit, interest rate, liquidity, price, foreign currency translation, transaction, compliance, strategic, and reputation. For the first seven risk categories the OCC makes the following assessments:

- **Quantity of risk** is the level or volume of risk that exists and is characterized as low, moderate, or high.
- **Quality of risk management** is how well risks are identified, measured, controlled, and monitored and is characterized as strong, satisfactory, or weak.
- **Aggregate risk** is a summary judgment about the level of supervisory concern; it incorporates judgments about the quantity of risk and the quality of risk management (examiners weigh the relative importance of each). Aggregate risk is characterized as low, moderate, or high.
- **Direction of risk** is the probable change in the bank's risk profile over the next 12 months and is characterized as decreasing, stable, or increasing. The direction of risk often influences the OCC's supervisory strategy, including

how much validation is needed. If the risk is decreasing, the examiner expects, based on current information, aggregate risk to decline over the next 12 months. If the risk is stable, the examiner expects aggregate risk to remain unchanged. If the risk is increasing, the examiner expects aggregate risk to be higher in 12 months.

The other two categories of risk, strategic and reputation, are less quantifiable than the other seven. Although these two risks affect the bank's franchise value, they cannot be measured precisely. Consequently, the OCC has a modified risk assessment and measuring process for them. This process includes assessing aggregate risk and direction of risk.

### **3. Relationship of RAS and Uniform Ratings**

The risk assessment system and the uniform interagency rating systems are distinct yet closely related evaluation methods used during the supervisory process. Both provide information about a bank's overall soundness, financial and operational weaknesses or adverse trends, problems or deteriorating conditions, and risk management practices.

Because of their related characteristics, the risk assessment system and the ratings systems can and do affect one another. For example, examiners may rate aggregate and direction of credit risk in a bank with increasing adverse trends and weak risk management practices as "moderate and increasing" or "high and increasing." This risk assessment may influence the CAMELS component rating for asset quality downward, if the current rating does not reflect the appropriate supervisory concern. When the two methods are used in this manner, they provide an important verification of supervisory findings and planned activities.

The major distinction between the RAS and the CAMELS rating systems is the prospective nature of the RAS. The CAMELS rating system primarily provides a point-in-time assessment of

an institution's current performance. The RAS reflects both a current and a prospective view of the institution's risk profile. It requires examiner judgment about the quantity of risk, the quality of risk management, and the direction of risk in each bank.

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## **Overall Assessment Red Flags:**

- A composite, component, or specialty rating that is lower than in previous examinations. Directors are particularly concerned about ratings of 3, 4, and 5.
- High or increasing level of classified assets.
- "Matters Requiring Attention" or items of concern in the "Overall Conclusions" section of the report of examination.
- Many or repetitive violations of law.
- A risk category in which the rating is inconsistent with the risk tolerance of the bank.
- A risk category in which the quantity of risk is moderate or high and the quality of risk management is rated as weak.
- Reference to noncompliance with bank policy or recurring internal control deficiencies.
- Reference to an activity for which directors may be liable or subject to civil money penalties.
- Reference to noncompliance with one of the OCC's administrative actions (cease-and-desist order, formal agreement, memorandum of understanding, or commitment letter).
- A risk category that is rated moderate and increasing, or high.
- A risk category in which the direction of risk is rated as increasing.

### III. PROBLEM BANKS AND BANK FAILURE

To gain a better understanding of why banks fail, the OCC studied selected national banks that failed during the 1980s. The study showed that while poor economic conditions make it more difficult for a bank to steer a profitable course, the policies and procedures adopted by the board of directors have a greater influence on whether a bank will succeed or fail. Improperly functioning boards of directors and management were the primary internal cause of problem and failed banks. The quality of a bank's board and management depends on the experience, capability, judgment, and integrity of its directors and senior officers. Common oversight or management deficiencies identified in failed banks are listed below.

- Uninformed or inattentive board of directors.
  - Nonexistent or poorly followed loan policies.
  - Inadequate systems to ensure compliance with policies or law.
  - Inadequate controls or supervision of key bank officers or departments.
  - Inadequate problem identification systems.
  - Decisions made by one dominant individual.
  - Poor judgment in the decision-making process.
- Negative influence from insiders.
  - Lack of policies or inadequate audits, controls, and systems.
  - Insiders of poor integrity.
- Overly aggressive activity by board or management.
  - Liberal lending policies.

- Excessive loan growth compared with management or staff abilities, cost systems, or funding sources.
- Undue reliance on volatile liabilities.
- Inadequate liquid assets/secondary source of liquidity.
- Other.
  - Excessive credit exceptions.
  - Overlending.
  - Collateral-based lending and insufficient cash-flow analysis.
  - Unwarranted concentrations of credit.



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These publications are available on the Web at <http://www.occ.treas.gov> (under Public Information—Publications or Issuances).

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